

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Strickland Analyst: Kimberly Pantoja Bill Number: AB 296

Related Bills: See Legislative Telephone: 845-4786 Introduced Date: 02/08/99

History Attorney: Doug Bramhall Sponsor: Franchise Tax Board

SUBJECT: Penalty For Failure To File Upon Notice and Demand/5% To 25% of Tax

SUMMARY

This Franchise Tax Board-sponsored bill would amend the penalty for failure to file a personal income tax return upon notice and demand. The penalty would equal 5% of the tax (prior to the application of timely payments or credits) for each month or fraction thereof elapsing between the date specified in the demand notice and the date on which the return is filed, not to exceed 25% (the current credit percentage).

EFFECTIVE DATE

This bill would be operative on January 1, 1999, and apply to all demand penalties imposed after that date.

SPECIFIC FINDINGS

Existing state law authorizes the Franchise Tax Board (FTB) to issue a notice and demand for information and/or tax returns. Additionally, the law provides that if a taxpayer either (1) fails to furnish any information requested in writing by FTB or (2) fails or refuses to file a required tax return upon notice and demand, the department may add a penalty. This penalty is equal to 25% of the amount of tax (prior to application of credits, including withholding) determined from any available information or any deficiency tax assessed by the department concerning the assessment of which the information or return was required. This "demand penalty" is not assessed if the postal service is unable to deliver the notice because of an erroneous address. If the address is incorrect, department staff attempts to identify a more current address and, upon doing so, reissues the notice. Also, this penalty may not be assessed if it is determined that the failure to file the return or furnish information was due to reasonable cause, not willful neglect.

The department's audit staff will make every reasonable effort to obtain information necessary to conduct an audit and support its conclusions and recommendation. When the requested information is not furnished, the auditor will prepare and issue a formal demand for information. Audit staff will impose assessment of the failure to furnish information penalty in cases where the formal demand is refused or ignored.

The "demand penalty" may cause taxpayers to incur penalties where they actually have no tax liability due and payable. This penalty may be based solely on the information available to the department at the time of assessment.

Board Position:

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Department Director

Date

Gerald Goldberg

3/18/1999

This bill would amend the penalty for failure to file a personal income tax return upon notice and demand to pattern this penalty after the penalty for failure to file a return and failure to pay tax. As a result, this penalty for individuals would equal 5% of the tax (prior to the application of timely payments or credits) for each month or fraction thereof elapsing between the date specified in the notice and demand for filing the missing return and the date on which the return is filed, not to exceed 25%. The penalty would not change for corporate taxpayers.

Thus, **the bill** would ensure that the penalty for failure to file upon notice and demand is not overly burdensome, particularly for taxpayers who would have been due a refund had they timely filed their return.

Policy Considerations

The penalty for failure to file upon notice and demand has been criticized as excessive as the taxpayer is subject immediately to a penalty of 25% of the total tax liability, even if the taxpayer would have been due a refund had a return been timely filed. Assessing the penalty incrementally would impose a smaller penalty on taxpayers who respond more quickly to the demand and reserve the larger penalty for taxpayers who ignore the demand. Also, a taxpayer who does not file the return upon receiving the demand notice would still have an incentive to file the return in order to avoid a higher percentage penalty.

Implementation Considerations

This bill would change the amount and manner of calculating the penalty for failure to file upon notice and demand; however, the department's procedures for assessing the penalty would remain the same.

Currently in filing enforcement situations, a Notice of Proposed Assessment (NPA) is issued within 50-60 days after the issuance of the notice and demand for a missing return. The penalty amount is shown as part of the NPA. This conforms to the department's policy of advising taxpayers at the earliest opportunity of proposed assessments.

Under this bill, the notice and demand letter would advise the taxpayer that if a return (or an explanation of why a return is not required) is not filed within 30 days, the demand penalty will be imposed. Additionally, the letter would identify the demand penalty as being calculated as 5% of the tax for each month, or fraction thereof, elapsing between the date specified in the demand letter for filing the return and the date on which the return is filed. This bill would require changes to the department's procedures and systems, which are estimated to be moderate.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Based on available data and assumptions discussed below, penalty collections under the Personal Income Law (PITL) would be reduced as follows:

Estimated Impact of AB 296		
Penalties Imposed on or After		
January 1, 1999		
Fiscal Year Impact		
(In Millions)		
1999-0	2000-01	2000-02
(\$55)	(\$35)	(\$35)

The fiscal year 1999-0 impact is significantly larger due to an 18-month rather than a 12-month time period (all of 1999 and six months of 2000).

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Tax Revenue Discussion

The revenue impact of this bill would be determined by the difference in demand penalties levied under current law for failure to file a return and demand penalties that would be levied under the proposed change. Demand penalties assessed for failure to file a return under current law (predominantly from filing enforcement rather than audit) amount to approximately a net \$125 million annually (on \$500 million of computed tax under PITL) based on a two-year average. This bill would replace the current 25% of tax method with 5% of tax per month elapsing between the date specified in the notice and demand for filing the missing return and the date in which the return is filed.

According to sources in the department's filing enforcement program, approximately 50% of taxpayers respond within an average of two months from the date of the NPA. The remaining taxpayers respond six months or more after the issuance of the NPA. Had this bill been in effect for or 1998, demand penalties for failure to file a return would have totaled approximately \$92 million. Thus, these demand penalties would have decreased by \$33 million from the \$125 million actually collected.

For this estimate it is assumed that 50% of the individuals who currently respond between two and four months from the date an NPA is issued will respond, on average, 30 days earlier. It is not anticipated that the acceleration of responses for cases beyond four months will be significant. These individuals, for various reasons, typically respond after eight months from the date of the demand notice. In addition, it is assumed that demand penalties would increase at the projected rate of increase in tax liabilities offset by improved compliance efforts and enhancements (net increase estimated at 1%).

BOARD POSITION

Support. The Franchise Tax Board voted to support the language in this bill at its December 16, 1998, meeting.